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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

The economy is very strong. The last reported GDP growth rate was 4.2% in the second quarter, while the current GDP growth is estimated to be 4.4%. Unemployment is 3.9%. Consumer confidence is 138.4, the highest level since then dot.com internet/tech boom of 2000. Leading economic indicators continue to climb. The Purchasing Managers Index, registering 61.2, says that business continues to expand strongly. Inflation is increasing, but is still well under control at 2.7%. It doesn't get much better than this.

The stock market is hitting new highs. Despite a somewhat arbitrary definition, some say that the bull market is the longest in history. The third quarter of the second year of a presidential term, historically the second worst performer of the 16 quarters is now over. It showed underlying strength by turning in a good gain. The next three quarters have been the best consecutive quarters in the average 4-year term. Economic optimists have plenty to cheer about. Contrarians get squeamish when new high records are being set.

This issue of *Outlook & Trends* discusses why both may be right – for a time. The timing of the onset of a bear market or a recession is unpredictable, just as the severity of the eventual correction cannot be known in advance. Given that reality, it makes sense to enjoy the good times and sunshine while they last, but also be prepared to weather any storms that follow.

Sand Piles, Earthquakes and Markets

I was recently reminded of a book that discusses the causes and probabilities of unpredictable events, *Ubiquity: Why Catastrophes Happen*, by Mark Buchanan. The theme of the book suggests that the trigger of many natural events has no real relationship to whether the event turns out to be significant. The book describes research that simulated dropping grains of sand on a sand pile. Occasionally the falling grain creates an avalanche. Usually it does not. The outcome depends on the internal structure of the sand pile. If the grain hits the pile, but none of the sand in the pile is dislodged, nothing happens. On the other hand, if the grain hits another grain and it moves, and hits still more, like multiple strings of dominoes, a sand slide of unpredictable size occurs. Usually the slides are small. Researchers found that the greater size of the slide, the less frequently it occurred.

The same effect can be seen in earthquakes. Along a fault line there are often multiple small tremors and relatively few large earthquakes. The exact cause or timing of a large earthquake has not been predictable. The severity depends upon the length of the "fingers of instability" in the structure of the fault zone emanating from the trigger point. The relationship between frequency and severity is inversely exponential. Earthquakes that are twice as strong occur four times less frequently.

Another example of nature (human nature), the financial markets, behaves the same way. Researchers created a model using optimistic traders, pessimists and fundamentalists. When the simulated "traders" noticed price trends or excess valuation, they would change their propensity to buy or sell, affecting the other traders and their decisions (the sand pile). The result was rallies and declines similar to real market action. As before, there were many small moves and an occasional big one, with a frequency relationship like the sand model.

These models suggest that major bear market declines, while infrequent, can be triggered by no visible cause, but feed on a structural weakness in the economic environment. In 2008, the "finger of instability", in retrospect, was the extensive derivative market surrounding subprime mortgage loans. After the collapse ran its course, a more stable economic "sand pile" was left behind.

Today, central bank influence, accumulation of risky debt encouraged by extra low rates, tariffs and international trade could all be one of the fingers that gets hit at some unknown point. According to the models, just as there is no way to know at the outset when a 10% correction will occur, there is also no way to predict whether it will stop at 10.1% or go on to 50%, although the size and frequency relationship probabilities favor the 10.1% outcome. The problem is that we cannot know how far the vein of instability runs through the system until after the fact. It is reasonable however to expect that the longer the bull market runs, and the higher values get, the greater the chance there is for extending paths of instability through the economy, leading to a larger market event.

Where does this leave us strategically? The markets usually go up, like the dropping sand continuing to pile on, so for investors it is important to participate most of the time. But at the same time, some people who are sensitive to market returns, like many retired investors, cannot afford to take the chance of a 50% drop, or lose 11 years of returns (the S&P500 produced zero return from 2000 to 2011). For them, risk reduction strategies are in order. Just as home insurance protects against big casualty losses, risk-management is insurance for the markets.

Earthquakes are fast moving events. So are avalanches. Hurricane Florence was not. Once again, the exact trigger that started the hurricane will never be known, but the conditions that allowed it to grow are understandable. Once it appeared, it could be tracked while feeding on its own path of instability. Estimating the course provided sufficient time to warn the populace. Markets are similar. While big corrections are not predictable, trends can be recognized with the right strategies, and action can be taken to prepare and protect a portfolio.

The Fiduciary Rule Is Dead, Long Live the Fiduciary

The regulation from the Department of Labor, requiring people who give advice to those with retirement plan savings to act in the best interest of their clients, is dead. It was vigorously opposed by brokers and insurance (annuity) companies and was vacated by the Fifth Circuit Court of Appeals after the current administration's DOL decided not to defend an appeal. Brokers had begun to change their procedures and products to reduce or eliminate long standing conflicts of interest. They are now reversing course and re-establishing prior practices. As a consumer, be aware that many providers of financial products and services are first and foremost interested in sales. They are obliged to make sure a product is suitable for you, but not necessarily best for you, and their recommendations may be influenced by personal or corporate incentives.

One good outcome from the DOL attempt is that it has brought some public attention to the issue. This is something that we have tried to do in our small way for you over the years in *Outlook & Trends*. Having had the issue raised on the national level now, it will probably not disappear completely. The SEC has picked up the baton, and is floating a replacement "best interest" regulation that appears to be more to the industries' liking. In the interim, there are advisors, primarily fee-*only* advisors, who voluntarily act as a fiduciary on their own accord. They will continue to do so regardless of regulation status. Although we are admittedly biased on this topic, we suggest that you seek out these organizations. It is not necessary to wait for the SEC to provide clarity, you can do it yourself. Ask prospective advisors and your own current financial providers, if they practice as a fiduciary.

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You do not need to ask LFM&P if we act a fiduciary. We have followed this practice since we began 16 years ago, long before the term became fashionable. *Outlook & Trends* has been our attempt to explain the other side to the industry narrative when necessary, and to provide information and a perspective that we hope is in your best interest with a minimum of self-promotion. It is possible however that some readers do not know how we might be able to help them, so we are breaking tradition today and are enclosing a sheet that describes our retirement planning. Next quarter we will be enclosing a similar sheet describing our investment services. If you are interested in finding a fee-only fiduciary investment advisor and would like the description now, send an e-mail or call, and we will send it to you.

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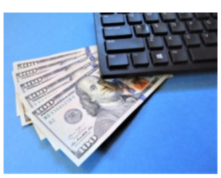
Retirement Planning and Management

After working for years, often supporting a family and saving industriously, the time to consider retiring arrives for everyone. Retirement can be a financial challenge because it could last a long time. It is also a challenge because the resources available during retirement are largely determined at the beginning and flexibility decreases as time progresses.

There are a number of important variables that can influence your retirement income and your ability to reach your retirement goals. Clearly your savings and your social security benefit are of great importance. Your retirement lifestyle is a very important factor. Investment selection can also make a significant difference. The way in which these elements contribute is different for each person. If possible, it is best to consider and plan retirement before actually retiring to see how your unique situation may evolve and whether any changes can be made early on to improve the overall outlook.

There have been many retirement rules of thumb that have been promoted over the years, such as "income tax rates are less in retirement", "investment asset allocation should become more conservative in retirement", or "it is best to contribute the maximum to a 401(k)". These examples of conventional wisdom may be true for some people, but certainly not for all. An *LFM&P* retirement plan considers the many facets of retirement. Those elements can determine whether the target date life-cycle fund that many 401(k) participants select is really the best choice, or even whether a savings vehicle other than a 401(k) is a better approach.

It is not unusual for people who have been working hard all their lives to pay little attention to their retirement investments, other than occasionally selecting a few choices from their 401(k) options. In fact, if they have worked for several employers, accounts may become scattered and become virtually unmanageable. This approach can work reasonably well during the asset accumulation phase of life, but retirement is different and requires rethinking accustomed ways. For example, retirement plans provide tax savings deferrals when working, but incur taxes in retirement. Investment market valuation can largely be ignored when working, but can make a big difference for retirement. When employed, taxes are largely determined by a W-2 form, but can be intelligently managed in retirement if different income sources have been created in advance.



Optimizing the financial aspects of retirement requires both planning and investment management. Planning is most important during the years preceding retirement through the time when Social Security benefits start. Management of investment risk (not necessarily risk reduction) remains important throughout.

During the retirement planning process, we meet with each client to get to know their financial situation, retirement plans and other life goals. We often ask many questions at that time, and later by e-mail, to clarify information that has been provided, and also to prompt clients to think about issues and details that they have not yet considered. We use the information and answers provided to construct a model, which projects how the client's financial future may look based on the ideas discussed, using reasonable assumptions about the future. The projection includes expected income and expenses, cash flow, taxes and wealth, and typically extends through age 100.

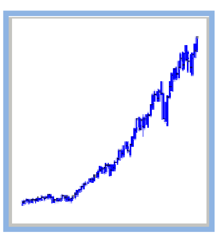
The model is created with several different variations in expense and investment asset ratios to see how sensitive the results are to changes in important variables. The process uses investment returns based on today's market valuation – not generic averages – and is also "stress tested" to see how objectives are likely to fare in a poor investment environment. The client can use the results of the analysis to adopt a mental framework that can guide both long-term and day-to-day financial decisions.

Typical questions that may be addressed are:

- When will I be able to retire?
- Will my money last?
- How do I minimize taxes, now and later in life?
- I have too much debt right now. How should I resolve this?
- My accounts are out of control. Can you help me get organized?
- Do my investment strategy and my investments make sense? Will they provide what I need?
- Should I rollover my 401(k)? Should I contribute to a Roth IRA?
- How do I plan for medical expenses?
- Does long-term care insurance make sense for me?
- When should I start my Social Security benefits?
- How should I structure my regular and my retirement accounts to provide tax advantages and income flexibility now and later?
- What's the best way to generate income to live on?
- How do I leave a legacy to my children or others?
- Do I have enough, or too much insurance?
- My employer is offering an early retirement buy-out. Should I take it?

Depending on the results of the modeling process, a client may decide to make changes to bring the anticipated result closer to their desired outcome. The plan details a financial path to achieve the results, and an understanding of what actions can be taken to bend a current course toward the desired outcome. Financial planning is an ongoing process. It needs to change as your life changes, so that you can make small changes to stay on course over time.

When clients work with *LFM&P*, they work directly with David and Barbara. David is a CFP® professional and member of NAPFA. *LFM&P* has been a fee-only, fiduciary organization ever since its beginning 2002. A planning relationship can be on a project basis or be continuing. A planning project provides a report detailing the analysis and recommendations as well as the opportunity for follow-up questions regarding the plan. Assistance with implementation is also available. In a continuing planning relationship, a plan is initially developed and the relationship continues indefinitely to address any financial issues that may come up during the time of the relationship. Since plans are kept up to date, newly developing financial issues may be considered more quickly.



Continuing planning may also be combined with investment advice or investment management. Because planning and investment are closely related, *LFM&P provides the lower fee service without additional charge.* We call the combination Wealth Advisor or Wealth Management.

The foundation of both Wealth Advisor and Wealth Management is our active MarketAware℠ approach, which couples risk-management with identification of investment opportunities that we believe are likely to be stronger than others. Our services and recommendations are structured and implemented for each client individually. We do not use generic "model" portfolios, or farm out the management process. As an Advisor, *LFM&P* monitors your portfolio and suggests changes periodically, typically every three to six months. You instruct your broker or 401(k) plan to execute the change. As a Manager, *LFM&P* reviews your portfolio continuously and handles changes for you when they are needed. The choice of Advice or Management largely depends on a client's personal preference and requirements. The fee schedule is the same for both and is based on assets advised or managed.

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